Insurance

M&A Insurance in Carve-Outs.

Given the changing M&A landscape, carve-out transactions are fast becoming a 'go-to' practice for organisations to grow their balance sheets with value-based management. Expectations are high that corporates will supply deal flow with asset disposals.

Securing optimal coverage

In Q1 of 2024, carve-outs were a significant source of Private Equity deal-making, accounting for 12.6% of all buyout deals, a 121.1% increase from Q4 2023, where 5.7% of all buyout deals were carve-outs[1].

The natural buyers for corporate carve-outs are specialist PE funds with a track record of undertaking these complex transactions, which require delicately separating assets from their parents and accurately cleaving balance sheets while causing minimal disruption. Without preparation, they can prove a challenge from a risk standpoint.

Due to the high complexity, detailed and thorough planning and preparation are required at the operational level, but also from a financial, accounting, tax and legal perspective. M&A insurance provides the cleanest way to reduce seller liability and encourage buyer confidence.

This article highlights some key areas to consider when preparing for such deals and advises future policyholders on risk management and how to secure fulsome insurance coverage.

Due diligence

As ever with W&I insurance, thorough due diligence is essential for providing M&A insurers with sufficient comfort to write the risk, and this is even more so with carve-outs. The broadest and in-depth due diligence exercise will provide greater clarity to the insurer, allowing the removal of exclusions and warranty amendments that would provide the most comprehensive coverage. Insurers must understand what is being carved out, how it is being executed and understand the target's future functionality. It is critical that the due diligence covers the target operating model and carve-out steps plan. Consideration of the geographical operational spread of the carved-out business should be taken when planning DD scope. Insurers will require diligence around the locations of the largest and material target operations.

It is common for business insurance (e.g., director's and officer's liability insurance, business interruption insurance, property insurance, etc) to be obtained on a group wide basis. In a carve-out transaction, the seller's group would not typically arrange for the target to obtain separate insurance prior to completion.

[1] Source: Carveouts provide greater deal reservoir for PE buyers - PitchBook

Instead, it would be left to the buyer to arrange its own insurance cover for the target after completion. It is highly important for a buyer to ensure that thorough due diligence and negotiations around insurance provisions have been conducted, and that sufficient and appropriate insurance policies are in place at the target level pre and post completion. The BMS Financial and Professional Risks can help secure necessary business insurance going forward.

Scope of the carve-out

A steps plans will often be drawn up to govern the various steps required for the operational and legal separation of the target business from the rest of the group. The carve-out plan is closely linked to the purchase agreement, which should provide a detailed legal framework for the implementation of the carve-out. Obtaining insurance is generally easier if the carve-out has largely taken place pre-signing, allowing insurers closer examination of the carved-out assets and relevant steps plan(s). If the carve-out occurs between signing and closing, insurers may amend their exposure to exclude certain risks. This is highly relevant to IP Rights and operational risks around the carve-out execution.

One of the key issues in a carve-out transaction is identifying the assets and liabilities which are to form part of the transaction. To address the risk that certain assets have been transferred to the buyer or retained by the seller when it was not intended by either party, a 'wrong pockets' clause is often included in the sale and purchase agreement for a carve-out transaction to reallocate those assets after completion.

Ensuring the target's smooth operation post completion is paramount. Sufficient protection for the buyer is optimal, in this regard, typically in the form of a Transitional Services Agreement (TSA). Under a TSA, post-closing, the buyer will benefit from operational services from the seller for a defined period. These are usually HR, IT, accounting and finance services etc. Employment risks can be mitigated with a contractual arrangement of transitional arrangements.

Some insurers may wish to exclude breaches from TSAs, so the effects of a potential TSA exclusion should be deliberated on prior to selecting a market.

Financial Statements

With regard to coverage for financial statements, it is important to understand whether the target group being sold have stand-alone audited accounts or whether their accounts are part of the consolidated group accounts. If a target has no stand-alone financial statements during a carve-out transaction, policyholders should expect extensive questioning through the underwriting process around the accounting assumptions of the pro forma carve-out financials. The importance of strong buy-side financial due diligence cannot be underestimated for securing optimal cover.

Insurers will get more comfortable if the pro forma accounts are audited. Ultimately, a 'true and fair view' standard will only be accepted for audited accounts. Unaudited accounts can normally only be insured if the financial warranties solely reflect the extent of the diligence around the accounts provision – a 'do not materially misstate' bar is held for unaudited accounts subject to due diligence.

Tax Liabilities

Correctly apportioning tax liabilities as well as allocating risk for potential tax exposures is often heavily negotiated in a carve-out sale. For example, ensuring that the correct amount of VAT has been allocated to the target group is a key issue and if the provision for VAT in the target group's financial statements is diligenced, then this can be covered by the W&I policy.

The steps involved in a carve-out are often multi-jurisdictional and complex. Depending on the nature of the steps (with commercial rationale being a key focus for tax authorities and therefore insurers), any potential tax exposure in completing the steps should be insurable under a tax policy, or under the W&I policy itself.

Sector
TMT

A US private equity acquiring a software management business from wider commodities trading platform.

EV: Undisclosed

Sector
Industrial

Acted for a US PE acquiring the UK arm of a French Plc supplying equipment systems to aid machine automation.

EV: £210,000,000

Sector
Financial Services

Acted for an Insurance Company on its acquisition of a digital MGA business.

EV: £400,000,000

Given the complexity, engagement with the BMS tax team as early as possible in the sale process is vital to ensure that the broadest cover at the most competitive pricing is achieved.

Coverage of these risks can be secured by the seller prior to approaching bidders (provided the steps plan is available in a progressed draft) clearing negotiating hurdles at the auction stage.

Equally, if the parties are comfortable with the reorganisation on the whole but have a concern about a particular step on the basis that, for example, it involves a distribution with a particularly high quantum, a tax policy can be used for this specific purpose.

Conclusion

M&A insurance is the cleanest way to reduce seller liability and grow buyer confidence in carve-out transactions. Additional considerations will be taken by underwriters, but assuming a thorough due diligence exercise has been undertaken, M&A insurance solutions can provide fulsome cover.

Experienced M&A brokers are invaluable assets in guiding policyholders through this specialist process.

At BMS Group, we cater for carve-out transactions for our clients. If M&A Insurance is of interest, please contact Tan Pawar, Managing Director, at tan.pawar@bmsgroup.com or Dean Andrews, Head of Tax, Restructuring and Contingent, at dean.andrews@bmsgroup.com

Product	Desscription
Tax Liability Insurance	Cover for identified tax risks emanating from current, pending or historical transactions or reorganisations. Tax Liability Insurance can shift the responsibility for tax issues from the insured to the insurer, thereby minimising financial risks, uncertainty and associated exposures.
W&I Insurance	Cover for financial loss incurred in relation to valid breaches of a warranty or representation pursuant to an acquisition agreement or a claim under a tax covenant or tax indemnity.
Contingent Risk Insurance	Cover to offset the risks associated with identified contingent liabilities that are capable of legal and/or accounting analysis.
D&O	D&O Insurance reimburses defence costs incurred by board members in defending claims against third parties alleging wrongdoing. D&O Insurance also removes the economic pressure of damages, settlements and awards resulting such claims.

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